NATIXIS ASSET MANAGEMENT

FIXED INCOME STRATEGY *WEEKLY*

WEEKLY ANALYSIS 29 MAY /// #18-2017

Document intended for professional clients

US growth revised up

Key Points

- **US growth revised to 1.2%qoq in 1Q17**
- **Investment driving US growth**
- **Risk of early elections rise again in Italy**
- **Neutral on T-note, slightly bearish on Bunds**
- **Stable credit spreads despite rich valuations**

Ten-year note yields sled last Thursday amid low volumes before Memorial Day weekend in the US. Treasury 10y bonds traded about 2.25% late last week. In turn Bund yields declined to 0.33%, a 7bp fall from a week ago. In the meantime, term structures of interest rates flattened. Gilt yields eased to just over 1% on 10y maturities.

As concerns euro area sovereign bonds, the risk of early elections is remerging in Italy. BTP spreads rose back to 185bps albeit with limited contagion across comparable debt markets. Swap spreads are modestly higher.

Credit markets have been trading sideways. The average spread in the corporate high-quality bond market is 108bps over German Bunds. Likewise, iTraxx indices trade respectively near 60bps on main and 250bps on crossover. The external debt market is seemingly ignoring the institutional crisis in Brazil. The dollar-debt spread tightened by 8bps to 300bps over US Treasuries.

US growth revised up

The US economy grew 1.2%qoqa between January and March. The preliminary estimate is 0.5pp above the advance GDP release. The softening in consumer expenditure has been confirmed. Demand for automobiles for instance contracted by fully 13.9%qoqa. Service spending growth was modest in the three months to March (+0.8%qoqa). Households did rebuild part of their financial savings which had fallen in the past three quarters. Weakness in consumption is likely to prove temporary given the high level of job creation, elevated household confidence and continued strength in housing investment. Residential investment added 0.5pp to GDP growth in the first quarter.

Business investment is actually driving US growth. Structures investment, including oil drilling, indeed increased by 28.4%qoqa last quarter. Business equipment expenditure and research and development rose 7.2%qoqa and 6.1%qoqa respectively in the period under review. Foreign trade added 0.1pp to GDP in 1Q17 thanks to 5.8% annualized export growth. Conversely, slower inventory buildup subtracted 1.1pp from GDP in the first three months of the year. Government spending fell 1.1%qoqa on the back of a 4% contraction in military expenditure and cutbacks in public construction.

In sum, final private demand growth stood at 2.7%qoqa in the first quarter. GDP growth may be stronger in the second quarter thanks to larger contributions from inventories and a pickup in private consumption. Durable goods orders are indicative of a softening in productive investment. Fiscal stimulus has hardly materialized. Foreign trade should be a touch less supportive.

Continued growth in the euro area

Economic surveys across the euro area all point to continued high growth in the second quarter. The IFO index stands at a 47-year high. PMI indicators will likely confirm widespread optimism in the euro area business community.

Net lending flows to the corporate sector were quite large at €8.2bn in April. That being said, non-financial corporate demand for funding remains highly heterogeneous across the economic and monetary union. In Italy, corporate loans outstanding declined by €5.2bn last month.

In the household sector, a sharp upturn in net lending can be observed. Monthly credit flows average €15bn in the past three months.

Neutral duration on US Treasuries, slight bearish bias on Bunds

The first week of the month is always the busiest in terms of US data. Full employment has been reached with unemployment rate down to 4.4%. Under 240k, weekly jobless claims are at historical lows. The economy will increasingly face constraints stemming from demographic trends. At the end of the day, this will dampen employment gains and raise domestic price pressures.

FOMC minutes reveal that Fed officials may soon unveil their plan to unwind the balance sheet. The expected rise in rates may exert flattening pressure on the US yield curve but any signal of lower reinvestment may have the opposite effect. Over the past few years, Fedspeak has always aimed at keeping market volatility in check. Implied volatility derived from US Treasuries options is down to 54bps according to the MOVE index, its lowest reading since 2014. Bearish consensus among final institutional investors runs against long positioning of active accounts and a "cautious" Fed. The fall back in oil prices bringing WTI below $50 likely added support to US bond markets. In this context, neutrality will prevail. Below 2.30%, technical analysis favors a long bias. The next US 10y yield target could be 2.17%. Meanwhile, should the Fed change gear, 10y note yields could move closer to fair value which is 2.74% on our estimates. Lastly, 10s30s spreads offer widening potential.

In the euro area, current economic conditions should warrant higher bond yields. However, the flash inflation estimate will likely point to inflation moderation in May. HICP inflation should diminish to 1.5%yoy from 1.9% a month ago. The 10-year yield in Germany is in line with the median level of the trading range since December. The 0.33% threshold should hold and promote a slight upward trend in euro yields. We retain a slight bearish bias on 10-year Bunds. The 10-year maturity is expensive in the curve. Relative value strategies such as selling 10y Bunds while buying 2y and 30y bonds have positive carry. This leads us to expect widening 2s10s spreads and flattening 10s30s.

As concerns euro sovereign bonds, investors have reduced their long exposure compared with two weeks ago according to JP Morgan's institutional survey.

Italy's political backdrop would be a source of volatility. The risk of early elections next autumn is back on investors' minds. Parties will have to design a new electoral law before June 30th if elections are to be held in September-October. No coalition is likely to gain a majority. Political uncertainty which would result from the announcement of early elections would justify higher spreads. Ten-year BTP spreads is trading near 185bps. In any case, To date, the resurgence of Italian political risk has had a limited impact on surrounding debt markets. Recent reallocation from Spanish Bonos onto Italian BTPs could start to lose steam. It is nevertheless worth holding an overweight stance on short-dated Italian bonds and Spain for maturities within 10 years. The Spanish Treasury will tap its 2066 bond for about €500mn this week. Lstly, the cyclical improvement in Portugal warrants a long PGB stance across the curve.

Economic backdrop favors credit

Like equities, credit tends to outperform risk-free assets when economic growth improves. CDS indices are trading near 60bps on ITraxx IG and a mere 250bps on Crossover. Technical signals argue for further spread tightening. Looking at current valuations, outperformance potential seems limited. In the corporate bond market, final investor credit exposure is rising again after a period of outflows around the French elections. The average IG spread is 108bps. Financials' excess spread vs. market indices has diminished in the past month.

Covered bonds have widened by 3bps last week to 53bps. We observe at last a small increase in high yield spreads to 302bps. High yield funds have indeed recorded modest outflows in the past few weeks.

Main Market Indicators

Government Bonds	29-May-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Bunds 2y	-0.72 %	-4	+2	+5
EUR Bunds 10y	0.3 %	-10	-2	+9
EUR Bunds 30y	1.13 %	-10	+3	+19
EUR Bunds 2s10s	101 bps	-6	-4	+4
USD Treasuries 2y	1.29 %	+1	+3	+11
USD Treasuries 10y	2.25 %	-1	-3	-20
USD Treasuries 30y	2.91 %	0	-4	-15
USD Treasuries 2s10s	95 bps	-2	-7	-30
GBP Gilt 10y	1.01 %	-8	-7	-23
JPY JGB 10y	0.04 %	-1	+2	-1
€ Sovereign Spreads (10y)	29-May-17	-1wk (bps)	-1m (bps)	Ytd (bps)
France	44 bps	-1	-8	-3
Belgium	37 bps	-2	-9	+4
Italy	188 bps	+14	-8	+28
Spain	126 bps	+3	-7	+8
Portugal	286 bps	+10	-37	-70
Inflation Break-evens (10y)	29-May-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR OATi	112 bps	-5	-16	-15
USD TIPS	183 bps	-2	-9	-14
GBP Gilt Index-Linked	306 bps	0	-4	+5
Swap Spreads (10y)	29-May-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Swap Spread	48 bps	+5	+1	+2
USD Swap Spread	-3 bps	+3	+1	+8
EUR Credit Indices (BarCap)	29-May-17	-1wk (bps)	-1m (bps)	Ytd (bps)
EUR Corporate Credit OAS	108 bps	+0	-5	-15
EUR Financials OAS	118 bps	-1	-7	-21
EUR Agencies OAS	48 bps	+1	-5	-9
EUR Securitized - Covered OAS	53 bps	+3	-2	-14
EUR Pan-European High Yield OAS	302 bps	+4	-32	-77
Currencies	29-May-17	-1wk (%)	-1m (%)	Ytd (%)
EUR/USD	$1.118	-0.49	+2.52	+6.29
GBP/USD	$1.285	-1.29	-0.55	+4.09
USD/JPY	¥111.31	-0.15	+0.4	+5.08

Source: Bloomberg, Natixis Asset Management

Selected Market Views

Government Bonds	Market View
EUR Bunds 10y	-1
EUR Bunds 2s10s	+1
EUR Bunds 10s30s	-1
USD Treasuries 10y	=
USD Treasuries 2s10s	=
USD Treasuries 10s30s	+1
Cross-Currency Spreads	Market View
USD Treasuries - EUR Bunds (10y)	+1
USD Treasuries - EUR Bunds (2y)	=
€ Sovereign Spreads - All Maturities	Market View
France vs. German Bunds	+1
Netherlands vs. German Bunds	-1
Belgium vs. German Bunds	=
Spain vs. German Bunds	+1
Italy vs. German Bunds	=
Other Bond Markets	Market View
EUR Index-Linked Bonds (Breakeven View)	= / +1
EUR Corporate Credit	=
EUR Agencies (vs. Swap Curve)	-1
EUR Securitized - Covered (vs. Swap Curve)	+1
EUR Pan-European High Yield	= / +1

Positions on a scale of "-2" to "+2", "=" stands for neutral
+1 is long (-1 is short) spread or duration or steepening view
Source: Natixis Asset Management

Writing

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